

ADOPTED 3/14/96

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)	
)	No. 93A-0691
Charter Point Homeowners)	
Association)	

Representing the Parties:

For Appellant:	Richard H. Wagner, Attorney
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For Respondent:	Edward J. Kline, Counsel
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OPINION

This appeal is made pursuant to section 19045 (formerly section 25666, subdivision (b)) of the Revenue and Taxation Code¹ from the action of the Franchise Tax Board on the protest of Charter Point Homeowners Association against proposed assessments of additional tax in the amounts of \$16,048, \$600, \$57,747 and \$35,315 for the income years ended December 31, 1988, December 31, 1988, December 31, 1989, and December 31, 1990, respectively.

¹ Unless otherwise specified, all section references hereinafter in the text of this opinion are to sections of the California Revenue and Taxation Code as in effect for the income years in issue.

The appellant is a nonprofit homeowners association which was granted tax-exempt status under section 23701t, effective October 21, 1981. At some point in time, on the behalf of its homeowner members, the appellant commenced a lawsuit against the developer of the property, based upon alleged construction defects. In the course of litigating that action, a settlement was reached, and sometime in 1988 the developer paid the appellant a settlement amount of \$9,500,000. Sometime in 1990, an additional settlement amount of \$74,754 was received by the appellant. The proceeds from the settlement which were not immediately used to correct the alleged construction defects were then placed in interest-bearing accounts, including government securities.

The main issue in this appeal is whether the appellant still qualified as an exempt organization under section 23701t during the income years on appeal, after receiving the interest income which accrued on the settlement amounts. Alternatively, the appellant also argues that, even if the interest income caused it to lose its exempt status, the fact that it is allegedly not “doing business” in California within the meaning of California’s franchise tax laws, makes it only subject to California’s corporate income tax, and interest earned on government securities is not subject to income tax.

Sections 23701 and 23701t define a tax-exempt “homeowners association” as an entity which is organized and operated to provide for the acquisition, construction, management, maintenance and care of residential association property, if

Sixty percent or more of the gross income of such organization for the taxable year consists solely of amounts received as membership dues, fees and assessments from tenant-stockholders, or owners of residential units, residences or lots.

(Rev. & Tax. Code, § 23701t, subd. (a)(1).)

Income which is attributable to membership dues, fees or assessments of owners of residential units or lots is referred to as “exempt function income.” (Rev. & Tax. Code, § 23701, subd. (c)(2); Treas. Reg. § 1.528-9 (a).) Further, because section 23701t is substantially the same as Internal Revenue Code (I.R.C.) section 528, both parties correctly refer to rulings and regulations dealing with I.R.C. section 528 as persuasive authority in interpreting section 23701t. (Douglas v. State of California, 48 Cal.App.2d 831 [120 P.2d 927] (1942).)²

Respondent determined that the interest earned by the appellant on the settlement proceeds was not exempt function income. Because said interest, when considered as non-exempt

² In fact, section 23701t was enacted as part of a bill which conformed some of California’s tax laws to newly-adopted federal tax laws.

function income, caused the appellant to have more than 40 percent of its income from “non-exempt” sources, the respondent revoked the appellant’s exempt status and issued proposed assessments on the interest-income amounts.

Appellant argues that the interest income in question was exempt function income, because it accrued on settlement amounts which were, in a sense, like assessments paid by the homeowner members. Appellant further argues that its holding of the settlement amounts was akin to a trust for the individual homeowners, and that the individual homeowners-beneficiaries would not be subject to California income tax on the interest received from government securities. (31 U.S.C. § 3124.)

Section 23701t requires that a homeowners association’s exempt status be withdrawn when too much of the association’s income comes from various commercial sources. In applying this test, the Board does not believe it was the intention of the Legislature to have an association’s exempt status revoked because of income which meets all of the following criteria:

1. The association earns interest income on its reserve account. Included in the definition of “interest income” would be earnings on investments in various bond mutual funds.
2. The reserve funds are necessary and appropriate.
3. The reserve funds are unusually large because they reflect the cost of repairing the property which has suffered as a result of developer malfeasance or a disaster.

It is the purpose of Section 23701t to provide homeowners associations with tax exempt status when these associations engage in traditional activities and avoid undue commercial activities. A homeowners association that operated a retail store or any other for-profit business might well lose its exempt status. Likewise, a homeowners association that built unusual and excessive reserves without any valid reason for doing so, and then invested those reserves in income producing investments, might also lose its exempt status.

In contrast, a homeowners association seeking in every way to perform only traditional activities should not lose its exempt status. Such a homeowners association may have particularly large reserves and interest income because it has received insurance proceeds or litigation settlements (or pre-litigation settlements) to repair property that has suffered from developer malfeasance or a natural disaster.

Therefore, we find that the appellant’s exempt status should not be revoked. Because of this finding, the “doing business” question is not being addressed.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Charter Point Homeowners Association, against proposed assessments of additional tax in the amounts of \$16,048, \$600, \$57,747, and \$35,315 for the income years ended December 31, 1988, December 31, 1988, December 31, 1989, and December 31, 1990, respectively, be reversed.

Done at Sacramento, California, this 14th day of March, 1996, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Dronenburg, Mr. Andal, Mr. Sherman and Mr. Halverson* present.

Johan Klehs _____, Chairman

Ernest J. Dronenburg, Jr. _____, Member

Brad J. Sherman _____, Member

_____, Member

_____, Member

*For Kathleen Connell, per Government Code section 7.9.